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SUBJECT: TURKEY'S ECONOMY: UPDATE ON REFORM MEASURES

REF: ANKARA 343

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1. (SBU) Summary: A GOT team of experts is drafting a letter of intent for the 2003 IMF program. IMF resrep hopes to receive the draft by this weekend, paving the way for an IMF mission as early as next week. The IMF focus remains the 2003 budget. While the GOT has formally committed to a 6.5 percent of GNP primary surplus, IMF resrep calculates a 3.5 percent of GNP shortfall towards that target, after figuring in the fiscal saving measures announced last week. The GOT's LOI drafting team is debating a second set of fiscal saving measures, but meanwhile State Minister Babacan appears to have announced a new spending measure - refinancing of Ziraat Bank loans to farmers. On structural reforms, progress is mixed: a good privatization program; very bad Public Procurement Law amendments, if adopted; and no forward movement on banking sector reform. End Summary.

Timing and Content of Letter of Intent

2. (SBU) A GOT team, led by Deputy Undersecretary of Treasury Aydin Karaoz, is drafting a letter of intent for the IMF. One participant, Central Bank deputy director of research Domac, told us the team is too large to come to agreement on many issues. Furthermore, per Domac, there is friction between Treasury staff (usually have the lead in relations with the IMF), and State Planning experts (who are closer to the AK Party). IMF resrep told us he was expecting the draft LOI by mid-week.

3. (SBU) Arrival of the IMF Mission tentatively slated for second half of January is conditioned on the contents of this LOI, and some amount of progress on outstanding structural reform conditions under the IMF Fourth Review. Resrep said the IMF staff have four "non-negotiable" elements: GOT and Central Bank commitment to a floating exchange rate (as "clean" as the current floating regime); a primary budget surplus of 6.5 percent of GNP; GOT commitment to the independence of the BRSA (so that it can take urgent clean-up measures with insolvent and undercapitalized banks); and GOT commitment to Central Bank independence.

Fiscal Policy - Talk of New Savings Measures,
But Also New Spending Announced

4. (SBU) The linchpin of the IMF program remains the 6.5 percent of GNP primary budget surplus. IMF resrep told us that, after the fiscal saving measures announced by PM Gul last week, Turkey still faces a 3.5 percent of GNP shortfall towards this 2003 target, or roughly \$6 billion. (The IMF assesses the real effect of the measures announced last week as 1.0 percent of GNP at best, though at face value they amounted to 1.7 percent. Resrep is skeptical that the "tax peace" law will result in any additional tax collection, noting that some payment of tax arrearages was already included in the revenue baseline assumptions.)

5. (SBU) IMF Mission Chief Kahkonen has sent a letter to Finance Minister Unakitan and State Minister in charge of Treasury Babacan warning that the "tax peace" law currently in parliament is "an unacceptable initiative," per the IMF resrep. This tax amnesty is too generous (establishes a very recent cut-off date for full tax collection of October 2002) and is not accompanied by measures to strengthen tax administration (in fact the AK government canceled such a

measure, the "Financial Year Zero" law). The "tax peace" law also contravenes a GOT commitment in prior LOIs not to adopt any tax amnesties. The law is still in parliamentary committee.

16. (SBU) Finance Ministry budget deputy director general Ahmet Kesik told us January 15 that the GOT team working on the LOI is considering a second set of fiscal saving measures. One large expenditure cut under consideration would expand the portion of civil servant wages subject to social security withholding. Such a move would have the effect of reducing civil servants net wages, and thus faces resistance.

17. (U) On the other hand, it appears that State Minister Babacan announced a new spending measure on January 14. In an interview with Bloomberg, Babacan announced that state-owned Ziraat Bank would reschedule farmers' loans. Comment: If the GOT has taken this decision, then it will, under the banking law amendments of 2001, have to budget the cost of writing down Ziraat loans - this will add to the 3.5 percent of GNP fiscal shortfall for 2003. End Comment.

Structural Reforms - Mixed Picture

18. (SBU) While there has been some forward movement on structural reforms (privatization), the GOT is attempting to backslide in one area (Public Procurement Law) and is not moving forward in another (banking).

19. (U) Privatization: The ambitious program announced January 13 was well received in the local press. The adoption of a detailed privatization plan for TEKEL should meet a prior action under the IMF Fourth Review (reftel).

110. (SBU) Public Procurement Law: The AK Party-proposed amendments to the Public Procurement Law would have the effect of watering down a key anti-corruption achievement of the 2002 reform program. IMF resrep told us the 40 different amendments under consideration in parliament would collectively reduce the scope of the new law to less than one third of GOT procurement.

111. (SBU) Others are lobbying against the Public Procurement amendments. The World Bank sent a letter to State Minister Babacan and Finance Minister Unakitan. According to WB economist Jim Parks, WB Vice President Linn has a talking point for his upcoming meeting with PM Gul that adoption of these amendments would result in suspension of all World Bank public sector lending to Turkey. (There are two tranches, together worth \$900 million, of WB lending scheduled for 2003). The EU Commission has written a letter to Treasury U/S Oztrak protesting the proposed changes, and EU embassies are attempting to organize a joint demarche against them as well.

112. (SBU) Despite public and private pressures not to proceed with the amendments, there are indications that AK intends to push them through. Minister for Public Works Zeki Ergezen told the press January 15 that "the Public Procurement Law amendments were temporarily halted (in committee) to make technical corrections, not because of criticism." Erdal Saglam, a Hurriyet columnist and Ankara insider, explained to us his view of the pressure within AKP to make these changes: "The AK leadership wants to help a group of businessmen in the same way that former President Ozal enriched a whole class of businessmen - through government contracts."

113. (SBU) Banking Reform: A key condition under the IMF Fourth Review is resolution of the ownership of two large banks - Pamuk and Yapi Kredi. Pamukbank was declared insolvent in June, and taken over by the BRSA; its sister bank Yapi Kredi is seriously undercapitalized but not yet insolvent.

114. (SBU) The Supreme Administrative Court (Danistay) decision to return Pamukbank to its owners was formally given to the BRSA on January 19, giving BRSA 30 days to return the bank to its owner Cukurova Holding. We understand from BRSA sources (Deputy Chairman Canakci) that Cukurova Holding is holding out for a "sweet deal" in its talks with BRSA; it wants return of the bank with the \$2.5 billion in GOT securities put in by the BRSA. Comment: The BRSA must by court order return Pamuk, but it cannot do so with the public

funds invested. Thus the BRSA will likely have to take over Pamuk once again - but will be reluctant to do so a second time without strong political support.

15. (SBU) To date, AK support for BRSA has been lacking. When challenged about BRSA actions on Pamuk and Yapi Kredi by an AK MP in parliament recently, Deputy PM Sener read out a statement prepared by the BRSA defending their actions. But when this statement was reported in the press January 12, Sener told the press he was just reading a prepared statement, he refused to endorse the BRSA.

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